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# Canada: Banking Troubles Ahead? [redacted]

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**An Intelligence Assessment**

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*September 1986*
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# Canada: Banking Troubles Ahead? [redacted]

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**An Intelligence Assessment**

This paper was prepared by [redacted] Office of European Analysis. It was coordinated with the Treasury Department. Comments and queries are welcome and may be directed to the Chief, West European Division, EURA, [redacted]

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*EUR 86-10036*
*September 1986*

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# Canada: Banking Troubles Ahead?

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**Key Judgments**

*Information available as of 25 August 1986 was used in this report.*

Depressed oil prices are undermining the stability of major Canadian banks at a time when they are expecting large loan losses from their extensive commitments to Latin American debtors and to the hard-pressed Canadian agricultural sector. Last year two of the country's smaller banks collapsed—the first such failures in 62 years. Ottawa is at present doing little to assist the banks or the energy sector, fearing in part that premature action would raise additional doubts about the viability of the financial system and hoping that an oil price rebound will solve the problem. All of Canada's major banks, however, are heavily committed to energy-dependent companies, particularly Dome Petroleum, which is teetering on the brink of bankruptcy. If Dome threatens to take a major bank with it, we believe Ottawa will intervene in either the energy or financial markets. Ottawa's various options are all politically or economically unpalatable, would in some way violate major tenets of Tory policy, and carry potentially damaging implications for Tory reelection prospects and for Canada's relations with the United States. 25X1

Because oil prices have recently stabilized, easing pressure on many Canadian energy companies, we believe the most likely scenario is Ottawa permitting Dome to fail, provided the government receives a guarantee that Dome's assets remain under effective Canadian control. Ottawa would then move in concert with major banks to stabilize the banking system by providing liquidity assistance to threatened financial institutions. Although much less likely, there are circumstances in which we believe Ottawa would intervene directly in the energy market. If, for example, Ottawa were not confident that Dome's assets would remain under Canadian control, it might order Petro-Canada, the state-owned oil company, to purchase Dome; or, in response to a sustained period of oil prices in the range of $5 to $10 per barrel, Ottawa might impose a floor price for Canadian oil. 25X1

A banking crisis could undermine the already shaky political future of the Mulroney government by irreparably tarnishing the Tories' reputation for fiscal competence. In addition, the need to shore up the banks would badly damage efforts to contain the budget deficit, probably halt movement toward deregulating the financial services sector, and reverse deregulation in the energy sector. It could also split the Tory Party between those who favor increased government involvement and those who advocate deregulation as the means of solving both the banking and energy problems.

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The Canadian Government almost certainly would look to the United States for assistance should a banking crisis appear imminent. It probably would press Washington for help in establishing an oil price floor and maintaining the stability of the Canadian dollar. While we doubt that a Canadian banking crisis would threaten the US financial system, US interests could be hurt indirectly if Ottawa applied controls to stem capital outflows resulting from a bank failure. Imposition of capital controls would disrupt the integrated US-Canadian capital market and create temporary trade frictions involving firms that rely on two-way capital flows. US firms also could easily lose potential opportunities for inroads into the Canadian financial or energy markets should Ottawa be forced to assume a more direct role in order to guarantee the stability of the financial system. The government would probably move to shore up the energy sector and restrict foreign takeovers of troubled Canadian firms, possibly by requiring foreign firms to divest new purchases within two years. Ottawa would also almost certainly be forced to freeze movement toward deregulating its financial markets and loosening restrictions on foreign firms operating in those markets. 25X1

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# Canada: Banking Troubles Ahead?

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## Introduction

Falling oil prices are threatening the stability of Canada's largest banks, only months after they had been the prime beneficiaries of the liquidity crisis that plagued Canada's smaller banks. Last year's problems resulted from the collapse of two regional banks—the first bank failures in Canada in 62 years—and created doubts about the efficacy of Canada's two-tier system of large and small banks. Current worries stem from the impact of low oil prices on the ability of large energy debtors—Dome Petroleum, in particular, which is on the edge of bankruptcy—to repay large and partly unsecured loans. Because all of its options for dealing with a potential banking crisis are politically or economically unattractive, the Mulroney government is hoping a rebound in oil prices will solve its problem. Ottawa may have little choice but to intervene in the energy market, however, because of the political importance of keeping Dome's assets under Canadian control and the danger that oil prices could drop to the range of $5 to $10 per barrel should the recent OPEC agreement unravel. This assessment explores the options open to the Canadian Government in dealing with a banking crisis, their drawbacks, the likely political fallout, and the implications for the United States.

## Last Year's Crisis

Worries about the Canadian banking system had arisen even before the most recent fall in oil prices and appear to be rooted in doubts about the effectiveness of federal regulatory procedures and the banking system's two-tier structure, which divides the country's 10 banks into six very large and four small institutions.[1] Financial nervousness came to a head last fall when two small regional banks in western Canada—the Canadian Commercial Bank and the Northland Bank—became insolvent as a result of numerous poor loans in the energy and real estate sectors. Ottawa immediately attempted a rescue effort in cooperation with the six major banks. When Ottawa finally realized the extent of the small banks' problem, it withdrew its support and the banks promptly collapsed—the first failures in Canada since 1923. These events not only drew heavy media attention and attacks on the government's management but also caused a crisis of investor and depositor confidence in the small banks. The ensuing liquidity crisis in the remaining small banks forced two—the Mercantile and the Morguard—to merge with larger banks (see figure 1). 25X1

Although the crisis has abated, deposits at two of the remaining small banks have been slow to return to earlier levels. From September 1985 to 30 April 1986, Continental and the Bank of British Columbia lost 40 and 33 percent, respectively, of their deposits, mostly as the result of withdrawals by large institutional depositors. Both are reported to have invested heavily in Albertan real estate and oil ventures, and are relying on short-term loans as liquidity support from the Bank of Canada—the country's central bank. The Bank of British Columbia recently closed 19 of its branches in other provinces, and Continental renewed the support package it arranged last fall with the Bank of Canada. This leads us to conclude that both the Bank of British Columbia and Continental remain likely candidates for a merger with a large bank. 25X1

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In the aftermath of the "crisis of confidence" caused by the 1985 bank failures, Ottawa appointed an independent inquiry board, the Estey Commission, to examine the federal role in the failures and to produce

[1] There are currently 10 chartered Canadian banks—down from 14 one year ago—six of which control 90 percent of the domestic assets of the banking system. See the appendix for further details on Canada's banking system.

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**Figure 1**
**Canadian Bank Assets**
**As of April 30, 1986**[a]

Legend:
- Big Six bank
- Mercantile merged with National Bank, Morguard with Security Pacific Bank of Los Angeles
- Forced to borrow from Canadian Central Bank
- Failed September 1985
- Little information available

Million US dollars

| | |
|---|---|
| Royal Bank | 71,448 |
| Bank of Montreal | 63,808 |
| Canadian Imperial Bank of Commerce | 57,219 |
| Bank of Nova Scotia | 46,146 |
| Toronto-Dominion Bank | 37,778 |
| National Bank | 18,980 |
| Continental Bank | 4,565 |
| Mercantile Bank | 3,200 |
| Bank of British Columbia | 2,241 |
| Canadian Commercial Bank | 1,950 |
| Northland Bank | 950 |
| Morguard | 200 |
| Western and Pacific | 100 |
| Bank of Alberta | 50 |

[a] With the exception of the failed banks whose assets are as of 7/31/85.

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recommendations for improving the regulatory system. Ottawa has pledged not to undertake significant regulatory reforms until the report is released later this year. In the interim, then Minister of State for Finance McDougall submitted draft legislation enabling regulators to stop certain questionable practices and provide an independent assessment of the value of a bank's assets, particularly real estate, as a way to begin the regulatory reform process. 25X1

**The Added Blow of Falling Oil Prices**

The rapid drop in oil prices this year has been the prod forcing Ottawa to consider a number of unpalatable options. The oil industry of western Canada has been hard hit, and several small firms are likely to go bankrupt if prices fail to rebound soon. Falling prices are also worrisome for larger firms—such as Dome Petroleum and Ocelot—which are already deeply in debt. Ottawa and the major banks took several steps in the past six months to minimize the impact of lower oil prices:

- The Federal Inspector General of Banks asked all banks to reveal the extent of their exposure to the energy sector as a possible first step toward regulations requiring special reserves against energy-related loan losses. We believe Ottawa moved with uncharacteristic speed to acquire information on energy loan exposure because such data would be crucial in arranging bank mergers on short notice in the event of a financial emergency.

- A number of major banks have increased their loan loss provisions, including the Royal Bank, the Bank of Montreal, Toronto-Dominion, and the Commerce Bank.[2]

- In addition, the Commerce Bank and Toronto-Dominion raised $113 and $92 million, respectively, in base capital—although there was speculation in the financial press that they broke security regulations in not revealing the troubles they were experiencing with their energy loans to Dome. 25X1

[2] The Royal Bank, although claiming the oil price situation is manageable, increased reserves in 1986 to $695 million, up $109 million from the estimate made three months earlier. The Bank of Montreal increased its provision for loan losses to $190 million, up $30 million from the year before. Most of the fund will be set against risks in the energy sector. Toronto-Dominion increased its loan loss provisions $35 million in the last three months, and placed loans to Dome in the nonaccrual category—meaning the bank will cease adding interest owed by Dome to income. Commerce increased loan loss provisions to $513 million, up $36.6 million from the previous quarter and also plans to place Dome's loans in the nonaccrual category in the third quarter. 25X1

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***How Dome's Difficulties Affect Major Banks***

***Commerce Bank.*** *We believe Commerce is the most vulnerable should Dome declare a moratorium or be put into receivership. Press reports indicate that Dome owes the bank more than $700 million, only 70 percent of which is secured by Dome assets. In addition, the assets pledged undoubtedly are worth much less than the value attached to them when oil prices were much higher. The bank has first call on Dome's shares of its original parent company, Encor, which are worth slightly more than $150 million. Commerce's ability to handle a Dome default, in our estimation, is weakened by its need simultaneously to address the nonperforming loans of Massey-Ferguson—a large farm machinery manufacturer that has been close to bankruptcy several times in recent years.*

***Toronto-Dominion Bank.*** *Dome owes Toronto-Dominion $586 million, 85 percent of which is secured by the company's assets. Again, however, Toronto-Dominion would not receive the full value of the pledged collateral because these assets have dropped sharply.*

***Bank of Montreal.*** *Dome owes the Bank of Montreal close to $700 million, which is well secured. The bank has first call on Dome's profitable business in natural gas liquids, which is relatively unaffected by oil price fluctuations. Income from this source would cover approximately half of the bank's exposure, effectively limiting the trouble Montreal might have realizing the full value of its collateral. In addition, the bank hopes to soften the shock of a Dome collapse with its strong profits in other areas, especially from its foreign investments. The Bank of Montreal is now the fifth-ranked foreign bank in the United States in commercial and industrial loans by virtue of the performance of its subsidiary, the Harris Bank Corporation of Chicago.* 25X1

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**Dome's Problems**

The current focus of concern about the impact of energy problems on Canadian banks is Dome Petroleum, which was viewed in the early 1980s as the showpiece of the Trudeau government's effort to reduce foreign ownership of its energy industry. Ottawa encouraged the major banks to make loans to Dome so that the company could finance its energy acquisitions. Canadian banks, unlike their US counterparts, compounded the potential for trouble by taking on entire loans individually rather than syndicating them. Dome owes its largest lender, the Commerce Bank, $700 million, only 70 percent of which is backed by Dome assets. The firm also owes more than $550 million to two other large banks, Toronto-Dominion and the Bank of Montreal (see inset). Dome took advantage of this permissive policy and borrowed $5 billion in the early 1980s to finance expansion, but the halt in the rapid rise in oil prices left the company on the brink of receivership. Dome finally managed to complete a debt-rescheduling agreement last year, but the fall in oil prices from $35 to $15 per barrel, in our view, has again jeopardized its survival. 25X1

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Dome's most recent troubles came to light in mid-March when the company announced plans to reschedule much of its debt due in 1986. [redacted] the unsecured creditors rejected the company's initial rescheduling proposal because debt repayment priorities could not be agreed upon. After difficult negotiations, during which the Commerce Bank reportedly had to talk a Citibank-led consortium of creditors out of placing Dome into receivership, the creditors granted Dome a reprieve. Dome now has until 31 October 1986, with a possible extension to 28 February 1987, to conclude another debt-rescheduling agreement. [redacted]

**The Government's Options**

Because of the government's budgetary constraints and carefully cultivated reputation for commitment to free market principles, Prime Minister Mulroney has apparently decided Ottawa can do little more at present to shore up Dome or the banks. Mulroney probably also fears that further actions would raise even greater doubts about the banking system. Consequently, Department of Finance officials are describing the problem as a private matter to be worked out between Dome and its creditor banks. [redacted]

The government's best hope appears to be a rebound in oil prices that would solve most of the energy sector's short-term problems without additional damage to either the banking system or the federal budget. Canadian officials also profess confidence that providing the banks a 5- to 10-year period to write down loan losses associated with the energy sector could absorb the negative impact of current energy problems. Responsible officials in the Finance Department, the Inspector General's Office, and the commercial banks have reported their unanimous optimism to the US Embassy that a Dome collapse will not cause the Commerce Bank to fail; none seem unduly worried about the overall financial system. They argue to US officials that their confidence is based on the substantial retail base of Canadian banks and on their diversified loan portfolios. [redacted] 25X6

[redacted] 25X6

In our view, Ottawa has only two realistic options should Dome's troubles endanger a major bank: either allow Dome to go bankrupt while finding a way to minimize the consequences—possibly by bailing out the major bank affected—or act directly to ensure Dome Petroleum's survival by government aid. Both of these options, as well as any variants we can think of, have strong political or economic drawbacks. [redacted] 25X1 25X1

***Bailing Out the Banks.*** The importance Ottawa attaches to maintaining Canada's control of the energy sector probably precludes letting Dome default if its assets cannot be retained in Canadian hands. Should the government fail to accomplish this, it would lose any chance of reaching the nationally cherished target of 50-percent Canadian ownership of the oil and gas sector by 1990 and induce bitter attacks on its economic and political competence. Canadian ownership of the oil and gas sector, currently 48 percent, could drop to less than 40 percent if Dome was acquired by foreign interests. If, on the other hand, the government is confident that Canadians will retain control of Dome's assets, it might gamble and allow Dome to go bankrupt, especially if Ottawa is reasonably confident that the banking system can handle the shock. The system's capacity to absorb a Dome collapse should grow throughout the year as bankers [redacted] increase loan loss reserves (see figure 2). [redacted] 25X1 25X1 25X1 25X1 25X1 25X1

Assuming Ottawa allows Dome to fail—currently the most likely scenario in our view, given the recovery of oil prices to the $15 range—it would probably choose between two alternative approaches to limit financial repercussions:

- Initially Ottawa, through the central bank, probably would join with the other major Canadian banks to ***provide loans to the Commerce Bank*** in the hope

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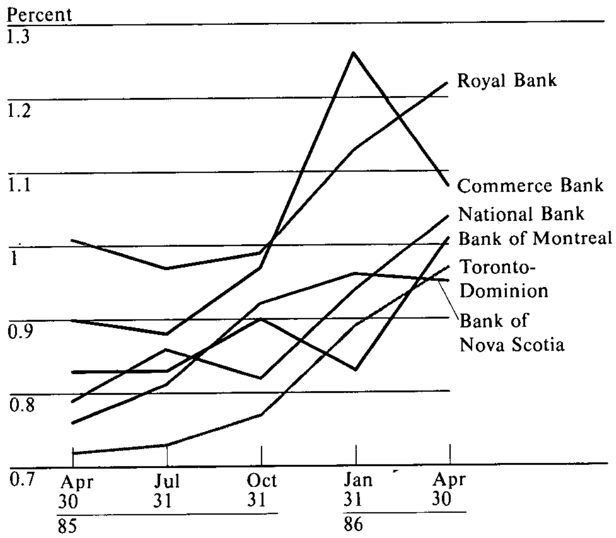
**Figure 2**
**Canada: Loan Loss Provisions as a Percentage of Outstanding Loans**

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that it could recover from its short-term problems and thereby restore confidence in the entire banking system. Such action by the government and large banks probably would be required for liquidity purposes in any case because media attention on Commerce's exposure almost certainly would cause a run on the bank. The Bank of Canada and the Finance Department both declared recently their willingness to lend as much as is needed to shore up a major bank. Most bankers reportedly believe Ottawa learned in 1985 that it cannot directly save even a small insolvent bank, hence the government's acceptance of bank mergers. Nonetheless, should a rescue of Commerce appear even remotely possible, some form of direct assistance almost certainly would be attempted.

***Bailing Out Dome.*** Although Ottawa seems prepared to let Dome fail rather than tamper with the free market, we believe there are circumstances that could force the government to intervene to bail Dome out. The cost of the bailout, should Ottawa go it alone, would probably be at least $2 billion, reflecting the currently poor market for disposing of oil-related equipment. This would be a significant blow to the government's deficit-cutting effort and would probably again result in severe downward pressure on the Canadian dollar. Because further depreciation is both politically and economically unattractive, we believe Ottawa would try the following scenario first in arranging a bailout for Dome (see figure 3): 25X1

- If Ottawa were not satisfied that the bulk of Dome's assets would remain under Canadian control in the increasingly likely event Dome's creditors exercise their legal option to put it into receivership, it might order Petro-Canada—the state-owned oil company—to purchase Dome. Although such an acquisition would permit the government to meet its 1990 commitment on Canadian ownership, the move has a number of drawbacks. We believe Petro-Canada would be reluctant to take on Dome's debts, and

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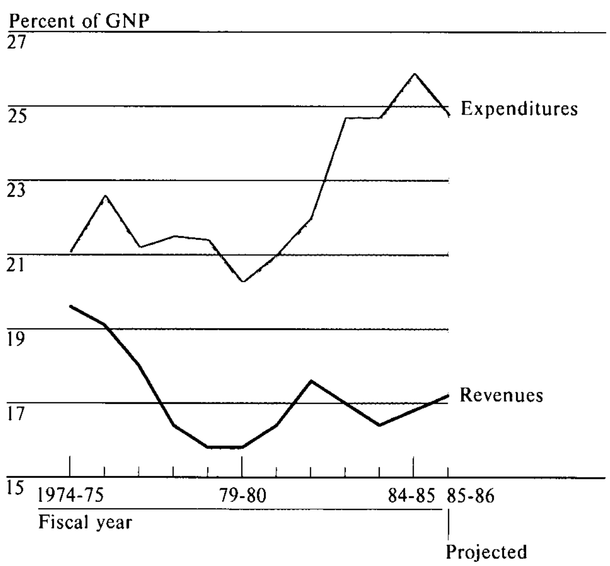
**Figure 3**
**Canada: Government Finances**

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Ottawa would probably have to provide some assistance, possibly in the form of loan guarantees or tax breaks. [redacted] The Tory Party itself could easily split between those who advocate deregulation and increased competition as the solution to economic problems and those who favor more regulation and governmental control. [redacted]

The level of oil prices will be a major influence on Ottawa's decision. Low oil prices would reduce the major banks' ability to withstand the shock of a Dome collapse because a large share of the bank's debts are energy related. A Dome collapse could also bring about additional—and unforeseen—strains on the banking system, [redacted] 25X1 25X1 25X1 Should the banks' assessment of their ability to absorb a Dome collapse prove optimistic, the Commerce Bank could be destabilized. If the banks convince Ottawa that low oil prices make a Dome bankruptcy too risky—which is unlikely as long as oil prices remain above $15 per barrel—the government would be left with two economically unattractive options:

- Oil prices in the range of $15 to $20 per barrel—the most likely outcome if the recent OPEC agreement holds—would ease immediate pressure on the energy sector but would not be enough to make Dome viable. Ottawa might in this case ***work out a rescue package for Dome in concert with the major Canadian banks.*** Because budgetary constraints discourage a continuing financial commitment by the federal government, any aid package would probably be a one-time deal designed to provide the banks time to build enough reserves to insulate them from a Dome bankruptcy or losses in the energy sector in general.

- Oil prices in the range of $5 to $10—which we believe are possible if the current OPEC accord fails—would probably force Ottawa to ***establish a floor price for oil produced in Canada and provide some extra aid for Dome.*** This step would do little to help Dome—Dome's chairman claims it needs at least $25 per barrel—but it would alleviate the short-term problems experienced by the energy industry. The government could pay for such a policy by either taxing oil imports or sharply raising its tax on gasoline. We believe that Ottawa would take this step only if an oil price collapse were destabilizing the banking system; after all, deregulating oil prices has been Prime Minister Mulroney's top economic achievement to date. [redacted]

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**Outlook and Future Vulnerabilities**

The next year will probably be an extremely difficult one for the major Canadian banks. The financial press is reporting that Dome is seeking to offer debt securities whose value hinges on the price of oil in exchange for having one-half of its debt written off,

***The Problems of Loans to Latin America and Canadian Agriculture***

*Apart from energy-related loans, another troubling question facing the major Canadian banks is their exposure to Latin debtors, especially oil-dependent Mexico and Venezuela. As a precaution against expected loan losses, the Federal Inspector General of Banks ordered the banks to set aside reserves equivalent to 10 to 15 percent of their outstanding loans to a group of 32 LDCs. According to available figures, the banks have either achieved, or are close to achieving, these targets.* [redacted]

*Additional concern for Canadian banks is exposure to Canada's agricultural sector. The* Financial Post, *Canada's leading financial paper, reports that low world grain prices and the growing prospect of an international grain trade war could drive a number of Canadian farmers into bankruptcy this year. The Royal Bank is the largest farm lender, with loans worth $3.9 billion. Thus far the Mulroney government has provided little help to the agricultural sector, although it is beginning to worry about its slump in the polls in traditionally pro-Tory western Canada.* [redacted]

**Estimated Loans to Key Latin Debtors as of December 1985**

*Billion US $*

| | LDC Loans | Mexico | Venezuela | Brazil |
|---|---|---|---|---|
| Royal Bank | **3.90** | 1.10 | 0.50 | 0.95 |
| Bank of Montreal | **3.75** | 1.30 | 0.45 | 1.30 |
| Canadian Imperial Bank of Commerce | **2.35** | 0.65 | 0.20 | 0.65 |
| Bank of Nova Scotia | **3.35** | 0.80 | 0.45 | 0.65 |
| Toronto-Dominion | **2.10** | 0.65 | 0.20 | 0.60 |
| National Bank | **1.60** | 0.45 | 0.15 | 0.45 |

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[redacted] 25X1

a stance that will probably harden if oil prices remain below $15 per barrel. It has also asked its unsecured European creditors to waive interest and principal payments until 28 February 1987. [redacted] As the deadline for a debt-repayment agreement approaches, one of Dome's well-secured lenders may decide it can obtain more revenue by placing Dome into receivership. [redacted]

The risks that a Dome default will destabilize the entire banking system are increased, in our view, by extensive loan exposure to LDC debtors, particularly oil-dependent Mexico, and to a Canadian agricultural sector hard pressed by low grain prices. A default by one of the large Latin debtors would diminish the major banks' capacity to withstand the impact of a Dome default. And continued low grain prices worry the banks because of their impact on Canada's already weakened agricultural sector, in particular firms dependent on agricultural business. For example, the fact that Massey-Ferguson—a farm implements manufacturer—was unable to pay its debts earlier this year contributed to the difficulties of the Commerce Bank—already the most likely casualty of a default by Dome Petroleum (see inset). [redacted] 25X1

**Implications for the Mulroney Government** 25X1

A major casualty of a Canadian bank failure, in our view, would be the Tories' reputation for fiscal responsibility—thereby worsening their already diminished chances for a second term. The Tories would no longer be able to lay claim to being the party best able to ensure financial stability. A bank failure would force Ottawa to choose between a sharply lower Canadian dollar and a prolonged period of higher interest rate differentials vis-a-vis US rates in order to protect its currency. The latter option, which Ottawa has taken twice in the past 18 months, would probably slow economic growth and raise further the 9.7-percent unemployment rate. A capital outflow, in response to uncertainty surrounding the stability of the Canadian dollar, would compound the growth slowdown because Canada is dependent on foreign

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capital to finance economic expansion. In an atmosphere of doubt about the banking system, Ottawa would almost certainly halt deregulation of the financial services system, something it [redacted] is committed to achieving. Prime Minister Mulroney would almost certainly be forced to replace Finance Minister Wilson, regarded by the business community as the government's sole symbol of deficit-cutting resolve. [redacted]

We doubt that a major bank failure in Canada would have much impact on the US banking system. Troubles in Canada's financial system would probably increase uncertainty about US banks highly exposed to the energy sector, but some of the larger US banks might benefit if corporations moved their funds out of Canada. More important, perhaps, would be the indirect impact of Canadian capital controls imposed to curtail excessive capital outflows and relieve heavy downward pressure on the Canadian dollar. Such a policy would disrupt the integrated US-Canadian capital market, resulting in some temporary trade frictions, especially among firms that require the use of two-way capital flows. [redacted] 25X1

US oil firms trying to expand their Canadian holdings would probably face new obstacles following a major Canadian bank failure. Ottawa would almost certainly move to bail out the Canadian-owned portion of the energy sector and would probably restrict foreign takeovers of troubled Canadian firms in order to salvage the hugely popular goal of increasing Canadian ownership in the energy sector. Moreover, selling energy assets at "fire sale" prices would cause the banks to receive only a fraction the value of their collateral. Texaco's recent offer for Sulpetro, for example, would only repay the Royal Bank approximately one-half the amount it lent to Sulpetro. Even if sales were allowed, Ottawa might require that the foreign firm divest control within two years. [redacted] 25X1

**Implications for US Interests**

Ottawa probably would be reluctant to admit that its financial system was in trouble, but, if convinced that a major banking crisis was on the horizon, the government would probably ask for US assistance. Canada might press for a price floor or target range for oil prices in the North American market as a method to stabilize its banking system; Canadian officials probably believe that the US could not refuse this request if the alternative were a destabilized financial market. In fact, the senior economist for the Royal Bank recently speculated that this would be a helpful development because low energy prices pose a threat to the US financial system as well. In addition, Ottawa would probably seek the aid of Washington and other G-5 members in propping up the Canadian dollar. The Canadian currency dropped sharply in March following speculation that the Bank of British Columbia was in difficulty. Should a major bank fail, substantial intervention would be required to maintain the value of the Canadian dollar. [redacted]

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## Appendix

## Canada's Banking System

Banking in Canada is regulated by the federal government, which is responsible for ensuring bank solvency, monitoring the industry's concentration, and establishing limits on the role of foreign firms. Banks are permitted to take deposits, issue loans, and invest in corporate securities. They are not permitted to offer fiduciary service or investment counseling. [redacted]

The Canadian banking system is composed of two types of bank—schedule A (domestic) and schedule B (foreign). The primary legal distinction between the two types of bank is that schedule A banks are widely held with a 10-percent ownership limit to individual shareholders, and a maximum total foreign ownership of 25 percent, whereas schedule B banks are closely held with no ownership restrictions. The domestic banks, 10 in all, are dominated by the "Big 6" banks, which have nationwide operations and control approximately 90 percent of the domestic assets of the banking sector. [redacted]

The federal government has the responsibility for regulation through the ***Inspector General of Banks.*** Owing in part to the inadequate size of the Inspector General's staff—numbering only 37 last year with responsibilities for examining 71 banks—the Inspector General often relies on the results of private-sector auditors appointed by the banks themselves. This "self-regulation" will be abandoned because Ottawa was severely criticized last year for taking action to save two banks without adequate knowledge of the full extent of their problems. One reform widely discussed is merging the office of the Inspector General of Banks with the inspector responsible for insurance firms in order to ensure more comprehensive scrutiny of the financial sector. [redacted]

The ***Canadian Deposit Insurance Company*** (CDIC)—created in 1967—is the sole federal government financial insurance plan. Although depositors are only insured up to $44,000 and deposits with terms exceeding five years are not insured, Ottawa, through the CDIC, has frequently guaranteed all deposits when trust companies have failed. As a result, the CDIC is now nearly $880 million in debt. Ottawa recently introduced legislation that tripled the insurance premium paid by financial institutions to 0.1 percent of the value of insured deposits. The government also hopes to reach agreement with the provinces on other changes in deposit insurance. Proposals include a special surcharge designed to eliminate the CDIC's deficit over a period of 10 to 25 years, the issuance of preferred shares, and a cash maintenance program to pay insured depositors immediately. [redacted]

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The ***Bank of Canada*** is the country's central bank and its primary function is to formulate monetary policy. The Bank of Canada has no formal jurisdiction over individual banking operations and does not speak for the banks on policy matters. It is the lender of last resort to other banks, however, and is active behind the scenes on banking issues, attempting to shore up troubled financial institutions. [redacted] 25X1

The 55 ***foreign banks*** operating in Canada—19 of which are US-controlled—are more closely regulated than domestic banks and are limited to a 20:1 asset/capital ratio. Citibank-Canada is the largest and most profitable foreign bank, but its assets are limited to approximately one-fifth those of the smallest Big 6 bank. Foreign banks are expected to target their loans at small- and medium-sized businesses, and requests for increases in capital are frequently judged by how well this criterion is fulfilled. In addition, foreign banks are limited to 16 percent of the domestic assets of the banking system. [redacted] 25X1

[redacted]

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